APPENDIX

APPENDIX A

Opinion of District Court

ORAL OPINION—JUNE 30, 1954

Forest L. Moe and Edith B. Moe vs. Hugh H. Earle, former Collector of Internal Revenue at Portland, Oregon. Civil No. 7074.

I have carefully examined the authorities cited in the four memoranda of law submitted by plaintiffs, and I have also examined all the authorities contained in defendant's memorandum. In addition, I have made an independent examination of the law.

I am well aware of the fact that the small amounts involved in this case are not indicative of the complexity of the problem and the impact that my decision will have on the members of the Hood River Apple Growers Association. For that reason, I had hoped to prepare a written opinion setting forth the various steps taken by the Association as reflected by its bylaws and the numerous amendments thereto as well as an analysis of the applicable decisions. Because of the press of other court work, I have found it impossible to prepare such an opinion within the immediate future. However, during the next two months I hope to have sufficient time to prepare such an opinion.

On the basis of *Davidson* v. *Apple Growers Association*, 159 Ore. 473 (1938), and the provisions of the Oregon laws dealing with co-operatives, particularly ORS 62.110 (2), 62.310, 62.330, and 62.020, and on the authority of *Estate of Wallace Caswell, et al.*, v. *Commissioner*, 211 F. 2d 693 (9 Cir. 1954), *Farmers Grain Dealers Association of Iowa* v. *U. S.*, 116 F. Supp. 685 (S.D. Iowa, 1953), and *B. A. Carpenter* v. *Commissioner*, 20 T.C. No. 82 (1953), I find that the amounts paid to redeem the "Certificates of Contribution to Revolving Capital Fund of Apple Growers Association—Hood River, Oregon," were income to plaintiffs in the years in which they were re-

deemed. In other words, I am of the opinion that they were not income either in the years in which the amounts were deducted or in the years in which the certificates were issued.

I am well aware of the fact that this finding does not agree with the contentions of either the plaintiff or the defendant in this case, but I believe it is in accord with the authorities above cited, as well as with numerous other decisions defining income.

Attorneys for the defendant shall prepare findings of fact, conclusions of law, and a judgment in favor of defendant in accordance with this oral opinion. (R. 52-53).

APPENDIX B

Opinion of Court of Appeals

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 14,623

Oct. 28, 1955

FORREST L. MOE and EDITH B. MOE, *Appellants*,

v.

HUGH H. EARLE, Former Collector of Internal Revenue at Portland, Oregon, *Appellee*.

Appeal from the United States District Court for the District of Oregon

Before: STEPHENS, HEALY, and CHAMBERS, *Circuit Judges*

PER CURIAM:

This appeal raises complicated questions of income taxation in regard to the withholding of a portion of the proceeds derived from the handling and marketing of apples by a cooperative organization. The appeal is from a judgment of the district court by which the court denied to taxpayer a refund of amounts paid under protest.

The judgment is affirmed without a reasoned opinion because we adhere to the general principles expressed in our opinion in the case of *Caswell's Estate* v. *C. I. R.*, 1954, 9 Cir., 211 F. 2d 693, See also *C.I.R.* v. *Carpenter*, 1955, 5 Cir., 219 F. 2d 635.

(Endorsed:) Per Curiam Opinion. Filed Oct. 28, 1955.

(R. 175) PAUL P. O'BRIEN, *Clerk*.

APPENDIX C

Judgment of Court of Apeals

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 14,623

FORREST L. MOE and EDITH B. MOE, *Appellants,*

v.

HUGH H. EARLE, Former Collector of Internal Revenue at Portland, Oregon, *Appellee.*

JUDGMENT

Appeal from the United States District Court
for the District of Oregon

This cause came on to be heard on the Transcript of the Record from the United States District Court for the District of Oregon, and was duly submitted.

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this cause be, and hereby is affirmed.

(ENDORSED) Filed: Oct. 28, 1955

PAUL P. O'BRIEN, *Clerk.*

(R. 176)

APPENDIX D

STANDARD CO-OPERATIVE GROWERS CONTRACT

of the

APPLE GROWERS ASSOCIATION
of Hood River, Oregon

Adopted on the 4th day of April, 1914, by a mass meeting of the growers and readopted on the 16th day of April, 1914, by the Board of Directors of the Apple Growers Association.

THIS CONTRACT, made and entered into, in duplicate, this 9th day of December, 1929, by and between the Apple Growers Association, a Co-operative Corporation of Hood River, Oregon, hereinafter called the Association, party of the first part and Forrest L. Moe of Hood River, Oregon, hereinafter called the Grower, party of the second part, in the manner following:

The said parties hereto, for and in consideration of the sum of One Dollar, to each in hand paid, the receipt whereof is hereby acknowledged and confessed, have and do agree as follows, to-wit:

The said Grower hereby transfers and agrees to deliver to the Association his entire crop of merchantable apples, pears, strawberries and other fruits for the year 1929, and every year thereafter, continuously, provided that the Grower may cancel this contract on March 31st of any year by giving written notice to the Association on or before March 20th of such year that he desires the same cancelled, and delivering his copy of the contract to the Association and paying any indebtedness due to the Association from the Grower. The failure of the Grower to so notify the Association and comply with the provisions aforesaid shall operate to continue this contract in force until such notification shall be given at the proper time, and the other stipulations aforesaid shall likewise be complied with.

The Apple Growers Association is hereby expressly authorized to pledge, hypothecate or otherwise offer for collateral the fruit mentioned in this contract for the purpose of meeting the current expenses of the Association, including necessary harvesting expenses advanced the Grower.

The Grower agrees to haul and pack his fruit in accordance with the methods and rules prescribed by the Association and to deliver the same free of expense to the Association at Hood River—(or if delivered to any other shipping point, freight and switching charges to Hood River to be borne by the Grower)—at such time as may be designated by the Association. The Grower further agrees to comply with and conform to all of the rules, regulations and requirements of the Association.

The Association agrees to handle and market the Grower's fruit with due diligence; and to pay the Grower such advances from time to time as sales warrant and to pay the balance of the net proceeds obtained by it for the fruit within thirty days after the receipt of the money for each pool of fruit; it being agreed by the parties that all fruit delivered hereunder shall be pooled by the Association with other fruit delivered under similar contracts, according to size, tier, grade, variety and time of delivery, and that the proceeds of each pool shall be distributed by the Association pro rata among the growers having fruit in such pool. In case the Association shall pack the fruit, it shall be entitled to retain from the proceeds, as a packing charge, such sum as the Association shall from year to year determine. The Association shall be entitled to retain from the proceeds a further sum, not exceeding 10¢ per box, for the storage of such fruit as may be held and stored by it in Hood River County, Oregon, in cold storage, with the understanding that such storage charge is to be charged pro rata as against the entire variety so stored. The Association shall be entitled to retain from the proceeds of the fruit and products handled by it such further sum, as an

advertising, handling, distributing and marketing charge, as the Association shall from year to year determine.

It is further agreed that for the year 1929 the Association shall retain as a handling charge not to exceed 10¢ per package for strawberries, pears and apples and 5¢ for peaches or cherries in 10 lb. packages. It is further agreed that each member of the Association shall receive the same price per box for the same variety, size and grade of fruit in each pool, and that no grower shall be charged more for the services rendered to him than other growers holding similar contracts are charged by the Association for similar services.

It is further agreed that the Association shall be entitled to withdraw from any pool fruit subject to any defect impairing the value thereof, traceable to a diseased condition, which defect was not visible at the time of the receipt of the fruit, or was not noticed at such time, but developed later. Such fruit so withdrawn shall be handled by the Association on a separate account.

It is further agreed that this contract shall become operative and binding upon the parties hereto whenever two-thirds of the shippers with the Association, holding contracts with the Association in the form adopted in 1913, have executed the foregoing contract and not otherwise, in which event the said growers contract, adopted in 1913 between the parties hereto shall immediately terminate.

In Witness Whereof, the Association has caused this contract to be executed by its duly authorized agent and the Grower has affixed his signature hereto this 9th day of December, 1929.

Apple Growers Association
By /s/ Victor Follenius
For the Association
/s/ Forrest L. Moe
Grower
/s/ Edith B. Moe

(Pet. Ex. 2)

APPENDIX E

Text of Regulations

Regulations 118-39.22 (a)-13

REG. 118, § 39.22 (a)-13. *Cancellation of indebtedness.*—(a) In general.—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. See § 39.22 (a)-17. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt. ...

Instructions—1948 Return

Instructions accompanying Form 1040, the form for reporting individual income taxes, for 1948, contained the following paragraph at page 10:

> "Farmers who market produce through a cooperative should add to the sales price of the produce, or to ordinary income, any patronage dividends received in the taxable year as a result of such transactions. Farmers who buy, through a cooperative, implements, gasoline, seed, fertilizer, or other items for use in their business should either reduce their deductions for such items by the amount of patronage dividends received or add patronage dividends to income. Patronage dividends received as rebates for purchases of items not used in your business should be omitted from your tax return. Patronage dividends are considered paid to you when remitted in cash, merchandise, stock certificates, or when credited to your account."

The foregoing appears to be the first public notice issued by the Bureau of Internal Revenue regarding the reporting of non cash patronage distributions of farmer coopera-

tives in the income tax returns of patrons. Advice to the same effect had been given by the Bureau in correspondence with the National Council of Farmer Cooperatives in 1943, but such correspondence was not published by the Bureau.

Income Tax Information Release No. 2

April 13, 1950

PATRONAGE DIVIDENDS

The earnings (savings) of farmers' cooperative marketing and purchasing associations, distributable to their patrons on the basis of the amount or value of produce furnished by them to the cooperatives of the value of supplies and equipment purchased by them from the cooperatives, generally are distributed to the patrons as patronage dividends in the form of cash or in one or more of the following forms:

Capital stock of the cooperative
Revolving fund certificates
Retain certificates
Certificates of indebtedness
Letters of advice as to net amount retained

For Federal income tax purposes, the amounts which are includible in the gross income of the patrons to whom such distributions are made are not restricted to amounts distributed in cash. Distributions by cooperatives in the form of capital stock, or in any form other than cash, should be included in the gross income of the patrons to the same extent that such distributions would be included if paid in cash. This rule is applicable to patrons who file their Federal income tax returns on the basis of cash receipts and disbursements as well as those who file their returns on the accrual basis.

E. I. MCLARNEY,
Deputy Commissioner,
Income Tax Unit.

Special Distribution.

Regulations 118-39.22 (a) 23

39.22 (a)-23 *Allocations by cooperative associations; tax treatment as to patrons*—(a) In general. Amounts allocated on the basis of the business done with or for a patron by a cooperative association whether or not entitled to tax treatment under section 101 (12) (B), in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section regardless of whether the amount allocated is deemed, for the purpose of section 101 (12) (B), to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the basis cash, accrual or otherwise, upon which the net income of such patron is computed.

(b) Extent of taxability. (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron or with respect to supplies, equipment, or services the cost of which was deductible by the patron under section 23, shall be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates or similar documents—

(a) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time required by 39.101 (12)-4 (a) (2).

(b) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as "reasonable reserves" under 39.101-4 (a).

(c) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in subdivision (a) of this subparagraph, or from amounts retained as "reasonable reserves" under 39.101 (12)-4 (a), referred to in subdivision (b) of this subparagraph. Where, in such case, the documents allocated are negotiable instruments, such documents shall be includible in the income of the patron to the extent of their fair market value at the time of their receipt.

(2) Amounts which are allocated on a patronage basis by a cooperative association with respect to supplies, equipment, or services the cost of which was not deductible by the patron under section 23, are not includible in the computation of the gross income of such patron; however, in the case of such amounts which are allocated with respect to capital assets (as defined in section 117 (a) (1)) or property used in the trade or business within the meaning of section 117 (j), shall, to the extent set forth in subdivisions (i), and (ii), and (iii) of subparagraph (1) of this paragraph, be taken into account in determining under section 113 the cost or other basis of the assets or property purchased for the patron. Approved May 29, 1953 (F.R. Doc. 53-4820; Filed June 2, 1953; 8:53 A.M.)

Revenue Ruling 54—10

Regulations 118, Section 39.22 (a)-23: Allocations by cooperative associations; tax treatment as to patrons.

(Cum. Bull. 1954-1, p. 24)

Internal Revenue Code

Allocations of cooperative associations and tax treatment as to patrons of amounts distributed in document form.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to set forth the policy of the Service and to furnish instructions to the district directors and other employees concerned, with respect to the tax treatment in the hands of patrons, of amounts allocated in document form by cooperative associations.

SEC. 2. MEANING OF TERMS.

For the purpose of this Revenue Ruling the terms "cooperative association," "patron," "allocation," and "patronage dividend" have the meaning ascribed to them in section 39.101 (12)-2 (b) of Regulations 118. As so defined the term "allocation" includes patronage dividends and other distributions made by a cooperative association in any manner whereby there is disclosed to the patron the dollar amount apportioned on the books of the association for the account of such patron. The term "patronage dividend" as defined does not include amounts allocated on a patronage basis in document form which are fixed without reference to earnings of the association. However, the rules set forth in section 6 herein, as to the tax treatment of amounts allocated in document form, apply not only to patronage dividends but to all allocations made by a cooperative association in document form.

SEC. 3. BACKGROUND.

.01 Treasury Decision 6014, approved May 29, 1953, C. B. 1953-1, 110, added section 29.22 (a)-23 to Regulations 111 (now 39.22 (a)-23 of Regulations 118), prescribing rules for the tax treatment as to patrons of allocations by cooperative association. Section 39-22 (a)-23 (b) (1) of Regulations 118 sets forth the extent of taxability of amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services the cost of which is deductible by the patron under section 23 of the Code. These regulations provide in part to the effect that if the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates or similar documents, the amounts allocated shall be included in the computation of the gross income of the patron to the extent of the face amount of such documents provided the allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated.

.02 These provisions as to the tax treatment of allocations in the hands of the patron where there is a contractual obligation involved do not represent a departure from the rules previously in effect, but set forth in regulation form a policy of the Service which has been long established.

.03 The regulations also set forth rules for the treatment of an allocation in document form where the allocation was not made pursuant to a valid obligation of the association to the patron. Normally in such case amounts so allocated are included in the gross income of the patron to the extent of cash or merchandise received in redemption or satisfaction of the document for the year in which the cash or merchandise is received. An exception is where

the document is a negotiable instrument, in which case the amount to be included in the gross income of the patron in the year of receipt is the fair market value of the document.

.04 The foregoing described treatment of allocations to patrons is consistent with the theory under which patronage dividends are treated by cooperative associations. A cooperative association may exclude from its gross income true patronage dividends when made pursuant to a prior agreement between the cooperative organization and its patrons. The justification for this treatment rests upon the fact that these patronage dividends represent either an additional consideration due the patron for goods sold through the association or a reduction in the purchase price of supplies or equipment purchased by the patron. The amounts which may be excluded as patronage dividends are not limited to the distributions made in cash but include amounts distributable but retained by the cooperative and distributed in forms other than cash. However, where a cooperative makes a distribution which it is not obligated to make under a preexisting agreement, it is not entitled to exclude such distribution from gross income even though the distribution is made on a patronage basis. Moreover, for taxable years beginning after December 31, 1951, in the case of exempt cooperatives and for all years in the case of cooperatives not exempt, any receipts of a cooperative association which it fails to allocate to its patrons must be included in the taxable income of the association to the same extent as in the case of commercial corporations generally. This is true of any amounts set up in a reserve account as well as net margins remaining after provision for reserves. It is also true of amounts which are considered to be in partial payment of produce, held back from patrons by a marketing cooperative, even though the association considers such amounts as fixed without reference to earnings.

.05 The theory under which a cooperative association may make an allocation in document form is that the patron by express contract or by doing business with the cooperative agrees to allow the association to retain funds to which the patron is entitled. Allocations other than cash or merchandise usually take the form of certificates denoting an investment in the capital of the association or of certificates of indebtedness by the cooperative. Where the document has been issued in accordance with a preexisting agreement, the form of the document is immaterial as to its taxability to the patron. It is considered that the patron has in effect received in money the face amount of the document and has either reinvested such amount in the capital of the association or allowed the association the use of the money. In either event there is justification for including the face amount of the document in the patron's gross income. This justification exists by reason of the preexisting legal obligation of the cooperative to distribute all of its net savings to its patrons each year and by the agreement between the cooperative and its patrons, which agreement is ordinarily set out in a marketing agreement or the association's charter, by laws, or both, whereby the patrons agree to accept other than cash or merchandise for their share of the net savings.

.06 An important problem regarding the treatment of allocations in document form has arisen in those cases where an allocation has been made by a cooperative association but the patron has failed to report the entire face amount of the document on his return as income. Of particular concern is the treatment of amounts received in redemption of documents issued in prior years where the period of limitations has expired for the year of allocation. The issue in such cases is the basis of the document to be used by the patron upon redemption, sale, or other disposition.

.07 There are precedents for holding that when a taxpayer has failed to include in his return property which

he received and which represents income to him he cannot in a subsequent related transaction shift his position so as to establish a basis for such property in excess of the amount carried into income in the year of receipt. A close analogy to the case of unreported noncash distributions by a cooperative association is found in decisions in which a taxpayer received shares of stock representing income in the year of receipt. An important case illustrating this principle is Continental Oil Company v. Jones, 177 Fed. (2d) 508, certiorari denied on the issue of duty of consistency 339 U.S. 931.

SEC. 4. STATEMENT OF POLICY.

In line with the decision in the Continental Oil Company case and other supporting cases the Service has adopted the following policy:

When a patron of a farmers' marketing or purchasing cooperative received capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents representing an allocation to him pursuant to a preexisting contractual obligation, or in any case in which the dollar amount of such allocation to him is disclosed in any other manner, and the patron reports the face amount of such allocation, the basis upon redemption, sale or other disposition of the evidence of such allocation is the face amount. In any such case in which the cash or merchandise received by the patron is less than the face amount, the patron may establish a loss under applicable provisions of the Internal Revenue Code. On the other hand when a patron receives similar evidence of an allocation to him and reports less than the face amount of the certificate or other document, his basis will be limited to the amount reported in income in the year of receipt thereof. Upon redemption, sale or other disposition of the evidence of the allocation the excess amount over the amount reported will represent gross

income to the patron in the year of such redemption, sale or other disposition.

SEC. 5. EXCEPTION TO GENERAL RULE.

Although the general rule just stated will apply in the great majority of cases where the patron has failed to report the entire face amount of an allocation in document form, there are situations in which an exception should be made. These are cases in which the period of limitations for the year of allocation has expired and before such expiration the Internal Revenue Service was on notice that the patron had included in his income an amount less than the face amount of his certificate or other evidence of allocation. As an example this notice might consist of information given in the patron's return from which the Service could have known that the patron received patronage dividends in document form and failed to include them in his gross income. In any such exceptional case the Service will not insist that there be included in income the amount by which the payment received in the year of redemption exceeds the amount reported in the year of allocation. However, in this type of case if the amount received upon redemption exceeds the face amount of the document, the excess would be included in income.

SEC. 6. COURSE OF ACTION.

.01 As a summary of the foregoing, the following rules should be used in determining the extent to which amounts allocated in document form by a cooperative association should be included in the computation of the patron's gross income.

1. Where an allocation was made pursuant to a pre-existing agreement:

a. If the period of limitations has not expired for the patron's taxable year in which the allocation was made, the amount of the allocation should be included

in the patron's gross income to the extent of the face amount of the documents.

b. If the period of limitations has expired for the patron's taxable year in which the allocation was made, the difference, if any, between the amount reported in the year of allocation and the amount received upon redemption, sale or other disposition of the documents should be included in the patron's income for the taxable year in which the redemption, sale, or other disposition took place.

2. Where an allocation was made which was not in pursuance to a preexisting agreement and the document issued was not a negotiable instrument the amount received upon redemption, sale or other disposition of the document should be included in gross income for the patron's taxable year in which received.

3. Where an allocation was made which was not in pursuance to a preexisting agreement and the document issued was a negotiable instrument:

a. If the period of limitations has not expired for the taxable year of the patron in which the allocation was made, the fair market value of the instrument should be included in the patron's gross income.

b. If the period of limitations has expired the difference between the amount reported in the year of allocation and the amount received upon surrender, sale or other disposition of the instrument should be included in the patron's gross income.

.02 An exception to the rule stated in 1.b. above will be recognized in any case in which the Internal Revenue Service had knowledge, prior to the expiration of the period of limitations, of the fact that the patron has included in his income in the year of allocation an amount less than the face amount of his certificate or other evidence of allocation. However, in any such case the Internal Revenue Service will be charged only with knowledge of the facts reflected in the taxpayer's return or discovered upon an investigation thereof.

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 639

FORREST L. MOE AND EDITH B. MOE, PETITIONERS

v.

HUGH H. EARLE, FORMER COLLECTOR OF INTERNAL REVENUE AT PORTLAND, OREGON

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact, conclusions of law, and oral opinion of the district court (R. 52–71) are not reported. The opinion of the court of appeals (R. 175) is reported at 226 F. 2d 583.

JURISDICTION

The judgment of the court of appeals was entered on October 28, 1955 (R. 176). The petition for a writ of certiorari was filed on January 25, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

During the years 1930 to 1937, a tax-exempt marketing cooperative deducted amounts which it received from the sale of its patrons' fruit and placed these amounts in its building and equipment fund. In 1942, pursuant to a 1940 amendment to its bylaws, the cooperative issued to its patrons certificates of contribution for these amounts. In 1949 and 1951, the cooperative redeemed these certificates for cash.

The question presented is whether the income from the sales of fruit was realized by petitioners when they received cash upon surrender and cancellation of the certificates (1949 and 1951), as held by the courts below, or whether, as argued by petitioners, the income from such sales was realized at the time and to the extent that proceeds from the sale of their fruit were deducted and retained in the cooperative's building and equipment fund (1930–1937).

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real

or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687] PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 42.)

STATEMENT

Petitioners are engaged in the business of growing and selling fruit in Oregon and are members of the Apple Growers Association of Hood River, Oregon. This association is a nonprofit agricultural marketing cooperative exempt from corporation income taxation under Section 101 (12) of the Internal Revenue Code of 1939. (R. 55–56.)

The "Standard Cooperative Growers Contract" entered into by the cooperative and petitioners (Pet. App. D) provides that fruit delivered to the cooperative each year by petitioners shall be pooled with fruit delivered by other growers, and that the cooperative shall pay to petitioners their pro rata share of the net proceeds of the pooled fruit within thirty days after the cooperative receives the money for that pool. A bylaw of the cooperative, which was in effect when petitioners became members of the cooperative and which remained in effect until 1940, provided for the creation and maintenance of a building and equipment fund out of charges levied by the cooperative upon amounts received from the sale of each patron's fruit. This fund was to be used by the cooperative exclusively for "the purchasing of or paying for property, equipment or betterments" for the benefit of the patrons in handling and marketing their fruit. (R. 55–57.)

After a pool was closed, the cooperative debited to each patron's account on pool-closing recap sheets various amounts, including the cooperative's operating charges for handling the fruit in that pool and the amount of the deductions for the building and equipment fund, and credited to the patrons their share of the cooperative's gross receipts. The cooperative then delivered to its patrons, including petitioners, pool-closing statements containing the same data as had been included on the pool-closing recap sheets. Along

with each pool-closing statement, petitioners received a cash payment or credit by the cooperative for the amount of the net credit shown in the statement after deduction for the amounts retained. (R. 57–59, 125–131.)

The total amount of the building and equipment fund deductions charged to petitioners and entered on pool-closing statements received by them for the years involved are as follows (R. 59–60):

For Association's Fiscal Year	*Amount*	*Year Charged to Plaintiffs on Pool Closing Statements*
1929–30	$140.46	1930
1930–31	261.48	1931
1934–35	78.76	1935
1935–36	116.99	1936
1936–37	100.25	1937

In August 1940, the cooperative's bylaws were amended by adding a provision to establish a revolving capital fund. The building and equipment fund was incorporated into the revolving capital fund. Under the new bylaw provisions the cooperative was authorized to withhold, as contributions to this fund, a percentage of the proceeds of fruit handled by the cooperative during the year. It was also provided that the directors should refund to its patrons amounts previously deducted for the building and equipment fund, in such an amount as in the judgment of the cooperative's directors was in the best interests of the cooperative and its patrons. Such refunds, however, were not to exceed, for any

fiscal year, the amount of contributions received in that fiscal year to the revolving capital fund, and the refund was to be prorated to growers who had contributed the earliest unrefunded amounts. Additionally, it was provided that at the end of each fiscal year certificates showing the net amount of the contributions and the year or years for which the contributions were withheld would be issued to each patron who contributed to the revolving fund. These certificates did not bear interest or confer any voting rights, and were not negotiable or assignable. (R. 60–65.)

In 1942, the cooperative issued to petitioners "Certificates of Contribution to the Revolving Capital Fund" covering each of the above noted amounts which had previously been charged to petitioners for the building and equipment fund.

In 1949, pursuant to a resolution adopted by its board of directors, the cooperative paid in cash to petitioners the sum of $401.94 upon cancellation of certificates previously issued to petitioners for amounts withheld by the cooperative in the years 1930 and 1931. In 1951, the cooperative paid petitioners the sum of $296 upon cancellation of certificates covering the years 1935, 1936, and 1937. (R. 65–66, 68–69.)

Petitioners did not file any income tax returns for any of the years 1930 through 1937, during which the cooperative deducted amounts for its building and equipment fund. Petitioners filed an income tax return for the year 1942, on a cash

receipts and disbursements basis, but they did not include any amount represented by the certificates issued to them in that year. In their income tax returns for 1949 and 1951, petitioners included as income cash received by them during those years upon redemption of these revolving fund certificates which had been issued to them in 1942. (R. 66–70.)

Thereafter petitioners filed claims for refund for so much of the taxes paid by them on their 1949 and 1951 returns as resulted from the inclusion in income of cash received by them during those years in redemption of certificates (R. 68, 70). Subsequently, petitioners brought suit for refund in the United States District Court for the District of Oregon (R. 3–21). The district court held that petitioners received income in 1949 and 1951, when they received cash payments in redemption of certificates, and that petitioners did not receive income in prior years, either when amounts were deducted from the sums of money payable to them for their fruit, or in the year in which certificates were issued to them (R. 70–71). The court of appeals affirmed the judgment of the district court (R. 175).

ARGUMENT

This case concerns the tax treatment of amounts distributed in document form by a cooperative to its patrons. The governing principles applied by the Internal Revenue Service and the rationale

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thereof are spelled out in Revenue Ruling 54–10, 1954–1 Cum. Bull. 24 (App. 17–25, *infra*), and need not be detailed here. See further Treas. Regs. 111, Section 29.22 (a)–23[1] (App. 15–17, *infra*). Broadly, as explained in these rulings, it is the position of the Service that where, pursuant to a pre-existing agreement, an allocation in document form is made by a cooperative association to a patron, the allocation is to be included in the patron's gross income in the year in which such documents are received to the extent of the face amount of the documents. Where, however, the allocation is not made in pursuance of a pre-existing agreement and the document issued (as here) is not a negotiable instrument, no amount is includible in the patron's gross income in the year in which the document is received, but the amount received upon redemption of the document is to be included in the patron's gross income for the year in which such amount is received.

Petitioners contend that they received income at the time and to the extent that proceeds from the sale of their fruit were deducted and retained in the cooperative's building and equipment fund (1930–1937) and that therefore the receipt of cash in the taxable years (1949 and 1951) in redemption of the certificates constituted a return

[1] This regulation was subsequently reissued as Treasury Regulation 118, Sec. 39.22 (a)–23 without change.

to them of capital invested in the cooperative, rather than a receipt of income (Pet. 2, 11, 23–4).

The court below, following its earlier decision in *Caswell's Estate* v. *Commissioner,* 211 F. 2d 693, held that the amounts received by petitioners upon the redemption of their certificates were taxable to them in the year of such redemption. In *Commissioner* v. *Carpenter,* 219 F. 2d 635, the Fifth Circuit reached the same result as the Ninth Circuit had reached in *Caswell's Estate,* that is, that the face amount of the certificates was not includible in the patron's gross income in the year in which such certificates were received. The Fifth Circuit apparently considered the presence of a pre-existing agreement in that case to be immaterial. There are no decisions in the courts of appeals directly in conflict with the decision below.[2]

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[2] Petitioners contend (Pet. 13) that the decisions of the Ninth Circuit in *Caswell's Estate* and of the Fifth Circuit in *Carpenter* are in conflict with one another and state that the Fifth Circuit would tax a patron to the extent of the fair market value of the documents received, whereas the Ninth Circuit would not tax a patron in any amount at the time the documents were issued to him regardless of the fair market value of the documents, if any. Inasmuch as the certificates involved in the instant case were not assignable and had no fair market value (R. 44, 64–65, 144–145), this question is not presented in the instant case and therefore the conflict between the circuits on this question, if in fact there be such, would not support the grant of certiorari. Moreover, it is not at all clear that *Caswell's Estate* and *Carpenter* are in fact in conflict, as contended by petitioner. While the Fifth Circuit in *Carpenter* alluded to the theoretical justifica-

While the underlying questions are of obvious importance, and we recognize that the governing principles are not settled, we submit that the instant case would not provide a suitable vehicle for a definitive ruling by this Court.

As noted above, under Revenue Ruling 54–10, the question as to the appropriate tax treatment of amounts distributed in document form to patrons turns on whether or not the distribution is made in accordance with a pre-existing obligation. See further Treas. Reg. 111, Sec. 29.22(a)–23 (App. 15–17 *infra*). The trial court made no finding as to the existence of a pre-existing obligation and the court of appeals did not mention

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tion for taxing the receipt of property with a fair market value (see 219 F. 2d at 636–637), it did not consider whether a patron would be taxed if the documents issued by a cooperative had a fair market value. It was agreed in that case (see 20 T. C. 603, 605) that the documents in question did not have a fair market value at the time they were issued.

Petitioners also claim that the decision below is in conflict with cases dealing with the tax treatment as to cooperatives of sums retained by cooperatives out of the proceeds of the sale of their patrons' products. *E. g.*, *San Joaquin V. P. Producers' Assn.* v. *Commissioner*, 136 F. 2d 382 (C. A. 9); *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201, 210 (N. D. Iowa). While it is the position of the Internal Revenue Service that the tax treatment of patronage dividends in document form as to patrons should be consistent with the tax treatment to the cooperatives of the amounts covered by such documents (see Rev. Rul. 54–10, Secs. 2.04–2.05 (App. 19–21, *infra*)), the existence of any such necessary correlation has been questioned. See *Carpenter* v. *Commissioner*, 20 T. C. 603, 607, affirmed, 219 F. 2d 635.

the point in its *per curiam* opinion.[3] Petitioners, however, have premised their petition upon the assumption that the cooperative was under a pre-existing obligation to them (Pet. 2, 14–15, 19–20, 23). But, an examination of the Standard Cooperative Growers Contract, entered into by petitioners and the cooperative on December 9, 1929 (Pet. App. 5a–7a), of the pertinent bylaws, particularly Section 7 thereof (R. 56–57) which provided for the retention of the proceeds in the building and equipment fund, and which provision was in effect when petitioners became patrons of the cooperative and remained in effect until 1940, casts doubt as to whether the cooperative retained these amounts in its building and equipment fund for the years 1930 through 1937, in accordance with any pre-existing obligation either to credit these amounts to petitioners' account, to issue to them pool-closing statements, or to return to them at any time the amounts which the cooperative had retained.[4]

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[3] In its brief in the court of appeals, the Government assumed without discussion that the allocations in question had been made by the cooperative in accordance with a pre-existing obligation to its patrons. The validity of this assumption was, however, questioned in a brief *amicus* filed in that court, wherein it was argued that under the governing bylaws of the cooperative and the Standard Growers contract in use no such obligation existed. See Brief of *Amici Curiae* in Support of Appellee, No. 14623, C. A. 9, pp. 6–12.

[4] Under the contract and bylaws, petitioner had no right to demand the sums retained by the cooperative in either cash or document form. The bylaws (Art. X, Section 7) provided for the retention, in the discretion of the board of

Neither petitioners nor the Government support the rationale of the decision of the court of appeals. Petitioners attack it as erroneous, assuming the presence of a pre-existing obligation, and on that assumption adopt the rationale of the governing rulings of the Internal Revenue Service. However, as already noted (*supra*, pp. 10–11), that assumption, although not challenged by any of the parties in the courts below, is shown by the facts to be at least of dubious validity. If, on the facts, no pre-existing obligation were found in this case, the result of the decision below would be supportable and consistent with the same Service rulings. See Rev. Rul. 54–10, Secs.

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directors, of limited amounts from the proceeds of the sale of patrons' fruit for a permanent Building and Equipment Fund. (R. 56–57.) The amounts involved were, in fact, retained from 1930 to 1937 by deductions from the proceeds of the patrons' fruit (R. 58–59, 128–129). These retentions were in accord with the applicable Oregon statute (1929 Supplement to Oregon Laws, Title XXXIX, Chapter VI, § 6970 (1929)), and this very bylaw has been interpreted by the courts of Oregon to permit these retentions but not to give patrons a right to recover from the Association amounts retained in the fund. See *Davidson* v. *Apple Growers Assn.*, 159 Ore. 473, 79 P. 2d 991. The provision requiring the Association to distribute in cash or in document form the amounts retained in the fund (Art. X, Section 9) was added to the bylaws in 1940, several years after the amounts involved in this case were retained (R. 60–65). Even then, in the documents issued on account of amounts retained, it was provided that the obligation of the Association to redeem the documents "becomes null and void after the membership under which said contributions were made shall be by any owner thereof cancelled, terminated or forfeited * * *" (see R. 12–21).

3.03, 6.01, para. 2, App. 19, 24 *infra*. Accordingly, whether the legal issue sought to be reviewed here is actually decided would depend on an appraisal of the facts. Such a factual inquiry by this Court is peculiarly inappropriate in a case where, as here, it was not fully litigated by the parties and resolved by the lower courts. In our view, moreover, even as to the cooperative involved, a decision in this case would be determinative only as to the tax treatment of amounts retained prior to 1940, at which time the by-laws were amended to provide for the issuance of documents to patrons on account of amounts retained by the cooperative for the Building and Equipment Fund.

Intertwined with the questions presented by this case are issues as to the taxability to cooperatives of sums retained out of the net proceeds of the sale of their patrons' products. Congress in 1947 and 1951 considered the broad aspects of the relationship between marketing cooperatives and their patrons, and the taxability of each for amounts received from the sale of products belonging to the patrons.[5] The complicated prob-

[5] See Treasury Tax Studies, The Taxation of Farmers' Cooperative Associations, Hearings before the Committee on Ways and Means, 80th Cong., 1st Sess., pp. 3127, 3135–3137; Hearings before the Senate Committee on Finance, 82d Cong., 1st Sess., on Revenue Act of 1951, Part 2, pp. 1250–1251, 1286, 1419–1436; S. Rep. No. 781, 82d Cong., 1st Sess., p. 21 (1951-2 Cum. Bull. 458, 473); Section 314 of the Revenue Act of 1951, c. 521, 65 Stat. 452, adding Sections 101 (12) (B) and 148 (f) of the Internal Revenue Code of 1939.

lems involved are under continuing administrative and legislative study.[6] This would seem to be a persuasive factor, in addition to those already stated, militating against further review at the present time of the question sought to be raised in this case.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted,

SIMON E. SOBELOFF,
Solicitor General.

CHARLES K. RICE,
Acting Assistant Attorney General.

LEE A. JACKSON,
KARL SCHMEIDLER,
Attorneys.

MARCH 1956.

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[6] See Letter of Secretary of the Treasury to Chairman, Committee on Ways and Means, House of Representatives, dated July 26, 1955, 101 Cong. Rec. (daily edition) pp. A5632–A5633.

APPENDIX

Treasury Regulations 111,[1] promulgated under the Internal Revenue Code:

> SEC. 29.22(a)–23 [as added by T. D. 6014, 1953–1 Cum. Bull. 110, 117]. ALLOCATIONS BY COOPERATIVE ASSOCIATIONS; TAX TREATMENT AS TO PATRONS.—(a) *In general.*—Amounts allocated on the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 101(12)(B), in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner disclosing to the patron the dollar amount allocated shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in (b) of this section, regardless of whether the amount allocated is deemed, for the purpose of section 101(12)(B), to be made at the close of a preceding taxable year of the cooperative association. The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the basis, cash, accrual, or otherwise, upon which the net income of such patron is computed.

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[1] This regulation was subsequently reissued as Treasury Regulation 118, Sec. 39.22(a)–23.

(b) *Extent of taxability.*—(1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services the cost of which was deductible by the patron under section 23, shall be included in the computation of the gross income of such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates, or similar documents—

(A) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated. For this purpose, it is immaterial whether such allocation was made within the time required by section 29.101(12)–4(a)(ii).

(B) To the extent of the face amount of such documents, if the allocation was made with respect to patronage of a year preceding the taxable year from amounts retained as "reasonable reserves" under section 29.101(12)–4(a).

(C) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the

time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in (A), above, or from amounts retained as "reasonable reserves" under section 29. 101(12)–4(a), referred to in (B), above. Where, in such case, the documents allocated are negotiable instruments, such documents shall be includible in the income of the patron to the extent of their fair market value at the time of their receipt.

* * * * *

Rev. Rul. 54–10, 1954–1 Cum. Bull. 24:

REGULATIONS 118, SECTION 39.22(a)–23: Allocations by cooperative associations; tax treatment as to patrons.

Allocations of cooperative associations and tax treatment as to patrons of amounts distributed in document form.

SECTION 1. PURPOSE

The purpose of this Revenue Ruling is to set forth the policy of the Service and to furnish instructions to the district directors and other employees concerned, with respect to the tax treatment in the hands of patrons, of amounts allocated in document form by cooperative associations.

SEC. 2. MEANING OF TERMS

For the purpose of this Revenue Ruling the terms "cooperative association," "patron," "allocation," and "patronage dividend" have the meaning ascribed to them in section 39.101(12)–2(b) of Regulations 118. As so defined the term "allocation" includes patronage dividends and other dis-

tributions made by a cooperative association in any manner whereby there is disclosed to the patron the dollar amount apportioned on the books of the association for the account of such patron. The term "patronage dividend" as defined does not include amounts allocated on a patronage basis in document form which are fixed without reference to earnings of the association. However, the rules set forth in section 6 herein, as to the tax treatment of amounts allocated in document form, apply not only to patronage dividends but to all allocations made by a cooperative association in document form.

SEC. 3. BACKGROUND

.01 Treasury Decision 6014, approved May 29, 1953, C. B. 1953–1, 110, added section 29.22(a)–23 to Regulations 111 (now 39.22(a)–23 of Regulations 118), prescribing rules for the tax treatment as to patrons of allocations by cooperative associations. Section 39.22(a)–23(b)(1) of Regulations 118 sets forth the extent of taxability of amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services the cost of which is deductible by the patron under section 23 of the Code. These regulations provide in part to the effect that if the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates or similar documents, the amounts allocated shall be included in the computation of the gross income of the patron to the extent of the face amount of such documents provided the allocation is made in fulfillment and

satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated.

.02 These provisions as to the tax treatment of allocations in the hands of the patron where there is a contractual obligation involved do not represent a departure from rules previously in effect, but set forth in regulation form a policy of the Service which has been long established.

.03 The regulations also set forth rules for the treatment of an allocation in document form where the allocation was not made pursuant to a valid obligation of the association to the patron. Normally in such case amounts so allocated are included in the gross income of the patron to the extent of cash or merchandise received in redemption or satisfaction of the document for the year in which the cash or merchandise is received. An exception is where the document is a negotiable instrument, in which case the amount to be included in the gross income of the patron in the year of receipt is the fair market value of the document.

.04 The foregoing described treatment of allocations to patrons is consistent with the theory under which patronage dividends are treated by cooperative associations. A cooperative association may exclude from its gross income true patronage dividends when made pursuant to a prior agreement between the cooperative organization and its patrons. The justification for this treatment rests upon the fact that these patronage dividends represent either an additional consideration due the patron for goods sold through the association or a

reduction in the purchase price of supplies or equipment purchased by the patron. The amounts which may be excluded as patronage dividends are not limited to the distributions made in cash but include amounts distributable but retained by the cooperative and distributed in forms other than cash. However, where a cooperative makes a distribution which it is not obligated to make under a preexisting agreement, it is not entitled to exclude such distribution from gross income even though the distribution is made on a patronage basis. Moreover, for taxable years beginning after December 31, 1951, in the case of exempt cooperatives and for all years in the case of cooperatives not exempt, any receipts of a cooperative association which it fails to allocate to its patrons must be included in the taxable income of the association to the same extent as in the case of commercial corporations generally. This is true of any amounts set up in a reserve account as well as net margins remaining after provision for reserves. It is also true of amounts which are considered to be in partial payment of produce, held back from patrons by a marketing cooperative, even though the association considers such amounts as fixed without reference to earnings.

.05 The theory under which a cooperative association may make an allocation in document form is that the patron by express contract or by doing business with the cooperative agrees to allow the association to retain funds to which the patron is entitled. Allocations other than cash or merchandise usually take the form of certificates denoting an investment in the capital of the association or of certificates of

indebtedness by the cooperative. Where the document has been issued in accordance with a preexisting agreement, the form of the document is immaterial as to its taxability to the patron. It is considered that the patron has in effect received in money the face amount of the document and has either reinvested such amount in the capital of the association or allowed the association the use of the money. In either event there is justification for including the face amount of the document in the patron's gross income. This justification exists by reason of the preexisting legal obligation of the cooperative to distribute all of its net savings to its patrons each year and by the agreement between the cooperative and its patrons, which agreement is ordinarily set out in a marketing agreement or the association's charter, bylaws, or both, whereby the patrons agree to accept other than cash or merchandise for their share of the net savings.

.06 An important problem regarding the treatment of allocations in document form has arisen in those cases where an allocation has been made by a cooperative association but the patron has failed to report the entire face amount of the document on his return as income. Of particular concern is the treatment of amounts received in redemption of documents issued in prior years where the period of limitations has expired for the year of allocation. The issue in such cases is the basis of the document to be used by the patron upon redemption, sale, or other disposition.

.07 There are precedents for holding that when a taxpayer has failed to include in his return property which he receives and which represents income to him he

cannot in a subsequent related transaction shift his position so as to establish a basis for such property in excess of the amount carried into income in the year of receipt. A close analogy to the case of unreported noncash distributions by a cooperative association is found in decisions in which a taxpayer receives shares of stock representing income in the year of receipt. An important case illustrating this principle is *Continental Oil Company* v. *Jones*, 177 Fed. (2d) 508, certiorari denied on the issue of duty of consistency 339 U. S. 931.

SEC. 4. STATEMENT OF POLICY

In line with the decision in the Continental Oil Company case and other supporting cases the Service has adopted the following policy:

When a patron of a farmers' marketing or purchasing cooperative receives capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents representing an allocation to him pursuant to a preexisting contractual obligation, or in any case in which the dollar amount of such allocation to him is disclosed in any other manner, and the patron reports the face amount of such allocation, the basis upon redemption, sale or other disposition of the evidence of such allocation is the face amount. In any such case in which the cash or merchandise received by the patron is less than the face amount, the patron may establish a loss under applicable provisions of the Internal Revenue Code. On the other hand when a patron receives similar evidence of an allocation to him and reports less than the face amount of the certificate or other docu-

ment, his basis will be limited to the amount reported in income in the year of receipt thereof. Upon redemption, sale or other disposition of the evidence of the allocation the excess amount over the amount reported will represent gross income to the patron in the year of such redemption, sale or other disposition.

SEC. 5. EXCEPTION TO GENERAL RULE

Although the general rule just stated will apply in the great majority of cases where the patron has failed to report the entire face amount of an allocation in document form, there are situations in which an exception should be made. These are cases in which the period of limitations for the year of allocation has expired and before such expiration the Internal Revenue Service was on notice that the patron had included in his income an amount less than the face amount of his certificate or other evidence of allocation. As an example this notice might consist of information given in the patron's return from which the Service could have known that the patron received patronage dividends in document form and failed to include them in his gross income. In any such exceptional case the Service will not insist that there be included in income the amount by which the payment received in the year of redemption exceeds the amount reported in the year of allocation. However, in this type of case if the amount received upon redemption exceeds the face amount of the document, the excess would be included in income.

SEC. 6. COURSE OF ACTION

.01 As a summary of the foregoing, the following rules should be used in deter-

mining the extent to which amounts allocated in document form by a cooperative association should be included in the computation of the patron's gross income.

1. Where an allocation was made pursuant to a preexisting agreement:

a. If the period of limitations has not expired for the patron's taxable year in which the allocation was made, the amount of the allocation should be included in the patron's gross income to the extent of the face amount of the documents.

b. If the period of limitations has expired for the patron's taxable year in which the allocation was made, the difference, if any, between the amount reported in the year of allocation and the amount received upon redemption, sale, or other disposition of the documents should be included in the patron's income for the taxable year in which the redemption, sale, or other disposition took place.

2. Where an allocation was made which was not in pursuance to a preexisting agreement and the document issued was not a negotiable instrument the amount received upon redemption, sale, or other disposition of the document should be included in gross income for the patron's taxable year in which received.

3. Where an allocation was made which was not in pursuance to a preexisting agreement and the document issued was a negotiable instrument:

a. If the period of limitations has not expired for the taxable year of the patron in which the allocation was made, the fair market value of the instrument should be included in the patron's gross income.

b. If the period of limitations has expired the difference between the amount

reported in the year of allocation and the amount received upon surrender, sale, or other disposition of the instrument should be included in the patron's gross income.

.02 An exception to the rule stated in 1. b. above will be recognized in any case in which the Internal Revenue Service had knowledge, prior to the expiration of the period of limitations, of the fact that the patron has included in his income in the year of allocation an amount less than the face amount of his certificate or other evidence of allocation. However, in any such case the Internal Revenue Service will be charged only with knowledge of the facts reflected in the taxpayer's return or discovered upon an investigation thereof.

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